APPENDIX

I. OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

SMITH, *Circuit Judge:*

Prior to 1951, petitioner was an established Illinois corporation primarily engaged in the business of mining coal under the name Consolidated Coal Corporation. During 1950, overtures to Lehman Bros., a New York investment banking firm, had been made on behalf of the owners of the principal block of stock, with a view towards sale of the stock. Lehman Bros. located a buyer, the Ziegler Coal & Coke Company, which, however, as matters finally developed was interested only in purchasing the assets of Consolidated. The following transactions then took place: Lehman Bros. exercised the purchase options it had secured through an agent and became the owner of nearly 95% of the outstanding stock on February 28, 1951; on the same day Consolidated conveyed all its assets except cash and Treasury obligations to Ziegler in return for $3,900,000 cash and Ziegler's promise to pay 50% of all amounts received over $800,000 for certain "disposable properties" conveyed by Consolidated which were to be sold. Immediately on receipt of the cash payment, the directors of Consolidated declared a partial liquidating dividend nearly equivalent to the amount of the payment. This, of course, went mainly to Lehman Bros. At the same time, Consolidated filed a statement of intent to dissolve with the Illinois Secretary of State. Consolidated had sustained a loss on the sale of the assets of $3,509,043.57 and a net operating loss of $3,466,387.52 for 1951.

Consolidated remained dormant throughout 1951 and early 1952, declaring a further dividend in partial liquidation during this period. In March of 1952, Ziegler liquidated Consolidated's interest in the disposable properties for $250,000 cash, the agreement also requiring that Consolidated immediately take steps towards dissolution. Instead,

the Consolidated directors began to search for some new field of endeavor which the corporation might enter. This quest culminated on April 6, 1953 in the purchase of the stock of three closely-held corporations, Ketay Manufacturing Corporation, Kinetix Instrument Company, and Ketay Research & Development Company (hereafter called the Ketay Companies), engaged in the manufacture and sale of precision electronic equipment. The total consideration was $2,275,000, later increased by $25,000, of which $100,000 was payable as a cash down payment and the balance in instalments over the next five years. The restrictive agreement with Ziegler was cancelled by mutual consent at about this time. Consolidated changed its name to Ketay Manufacturing Corporation, dissolved the three Ketay Companies, and took over their assets and management. The stockholders of the three companies were allowed to purchase newly issued Consolidated-Ketay stock, which they all did, and all of them remained as officers or directors of Consolidated-Ketay.

The corporation reported taxable income for 1954 from its electronics business of $1,007,623.38 before net operating loss deduction. It carried over a net operating loss from 1951 of $2,304,125.58 which had resulted principally from the sale of the coal-mining assets. After deducting this loss, the corporation reported a net loss for 1954 of $1,296,502.20. The Commissioner of Internal Revenue, by his notice of deficiency, disallowed the claimed net operating loss deduction. Petitioner seeks review of the decision of the Tax Court sustaining the asserted deficiency.

The applicable law is to be found in the Internal Revenue Code of 1939. See I. R. C. of 1954 § 172(g)(1). The particular provision that governs is I. R. C. of 1939 § 122, and the leading interpretation of the provision is to be found in the opinion of the Supreme Court in *Libson Shops* v. *Koehler*, 353 U. S. 382 (1957). Application of the principles of that decision to the facts of the present case lead us

to conclude that the decision of the Tax Court must be affirmed.

The precise question in *Libson Shops* was whether "a corporation resulting from a merger of 17 separate incorporated businesses, which had filed separate income tax returns, may carry over and deduct the pre-merger net operating losses of three of its constituent corporations from the post-merger income attributable to the other businesses." 353 U. S. at 382. Sixteen sales corporations had been merged into a management company without change in the actual business carried on by any of them. As the Supreme Court interpreted the statute, the legal problem upon which the case turned was the interpretation of the operative words "the taxpayer" in I. R. C. of 1939 § 122(b)(2)(C).[2] The purposes of the loss carry-over section, as revealed by the legislative history, yielded the solution:

> "The requirement of a continuity of business enterprise as applied in this case is in accord with the legislative history of the carry-over and carry back provisions. Those provisions were enacted to ameliorate the unduly drastic consequences of taxing income strictly on an annual basis. They were designed to permit a taxpayer to set off its lean years against its lush years, and to strike something like an average taxable income computed over a period longer than one year. There is, however, no indication in their legislative history that these provisions were designed to permit the averaging of the pre-merger losses of one business with the post-merger income of some other business which had been operated and taxed separately before the merger. What

[2] "* * * If for any taxable year beginning after December 31, 1947, and before January 1, 1950, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-over for each of the three succeeding taxable years. * * *"

prise—continuity of stock ownership. Where there is continuity of ownership, there might well be justice in allowing a loss carry-over even though there has been a complete change in the nature of corporate activity. The purposes of the statute are ultimately directed toward granting a legitimate tax advantage to the shareholders behind the corporate entity. See *Newmarket Manufacturing Co.* v. *United States*, 233 F. 2d 493 (1 Cir. 1956), cert. denied 353 U.S. 983 (1957). It may well be that shareholders who sustain a loss and then are wise enough to liquidate an uneconomic enterprise and embark on a different and profitable field of endeavor through the same corporation are equally entitled to offset the earlier losses as those who see an unprofitable corporation through the lean years into the good ones in the same activity. But there was no such continuity of ownership in the present case. The losses were sustained by the group of shareholders who sold their stock to Lehman Bros. at the same time that Lehman Bros. was engaged in selling the corporate assets at a price carefully calculated to yield a profit. It could hardly be contended that the investment bankers bore the ultimate incidence of the three million dollar loss on the sale of the assets that fell in the first instance on Consolidated; in fact, it is agreed that they made a profit of approximately $200,000 on the sale to Ziegler. Further, it is clear that the benefit of the 1954 profits accrued to an almost entirely different group of persons from those who suffered the loss. Former Consolidated shareholders retained at most a 3% ownership of Consolidated-Ketay at that time. Whatever percentage might be necessary to constitute substantial continuity of ownership, it is more than that.

As there was neither continuity of ownership nor continuity of enterprise between the period of loss and the period of gain, we find the "continuity of business enterprise" required by *Libson Shops* to be lacking. No intelligible legislative purpose would be served by permitting

a substantially new group of shareholders engaged in a different enterprise to benefit from the losses sustained by earlier owners in another business. In such a case, the corporate entity is the only link between them. The basic teaching of *Libson Shops* is that this is not enough. Decisions of the other Courts of Appeals in similar fact situations are in accord with this conclusion. See *J. G. Dudley Co.* v. *Commissioner*, 298 F. 2d 750 (4 Cir. 1962); *Commissioner* v. *Virginia Metal Products, Inc.*, 290 F. 2d 675 (3 Cir.), cert. denied 368 U. S. 889 (1961); *Willingham* v. *United States*, 289 F. 2d 283 (5 Cir.), cert. denied 368 U. S. 828 (1961); *Bookwalter* v. *Hutcheus Metal Products, Inc.*, 281 F. 2d 174 (8 Cir. 1960); *Mill Ridge Coal Co.* v. *Patterson*, 264 F. 2d 713 (5 Cir.), cert. denied 361 U. S. 816 (1959).

Petitioner seeks to distinguish these cases in several ways. First, it is argued that they involved "shell" corporations, unlike the present case. But this is to ignore the fact that Consolidated was for all practical purposes a "shell" for a long period of time, at least from the sale of all its operating assets in February, 1951 until the receipt of $250,000 cash from Ziegler Coal & Coke Co. in March, 1952. During this period, it had no significant assets except the unliquidated contract claim on Ziegler and engaged in no business activity. The only actions taken, declaration of liquidating dividends and filing of a statement of intent to liquidate, indicated instead that Consolidated was in the process of complete liquidation. A corporation with no tangible assets engaging in no business activity might fairly be called a "shell".

Next, petitioner states that the only reason for the acquisition of a new enterprise in the above-cited cases was to take advantage of a potential loss carry-over, whereas here there is evidence that Lehman Bros. bought the stock without knowledge of the potential loss carry-over and with the sole objective of selling the stock at a profit. But this

argument fails to recognize that findings under the loss carry-over provisions are independent of findings under I. R. C. of 1939 § 129, which would invalidate a transaction whose principal purpose was evasion or avoidance of taxes. In these cases, and in *Libson Shops* itself, the events were found not to permit a loss carry-over even though there was no Tax Court finding of an intent to evade or avoid taxes. Thus, whatever may be petitioner's view of the transactions at issue, the courts tested them without tax evasion being established. As was said in *Libson Shops*, "the fact that §129(a) is inapplicable does not mean that petitioner is automatically entitled to a carry-over." 353 U. S. at 389. The situation is the same here.

Finally, petitioner argues that the case is distinct because assets were purchased by the corporation rather than contributed by shareholders or acquired through merger. It should be recalled in this connection that a three million dollar group of companies was "purchased" for a down payment of $100,000, without security, by a corporation having no other assets than $250,000 cash and the loss carry-over potential. The shareholders of the companies "purchased" were permitted to acquire a substantial interest in the purchaser and to continue to take part in management. This fact situation could well be considered to be a *de facto* merger—with Consolidated contributing its loss carry-over. But we need not reach this position, for we find no significance in this type of "purchase." The contrary result would destroy the effect of *Libson Shops*, for any corporation with a loss history would be able to negotiate a like purchase, financing the future payments through the tax savings gained by applying the loss carry-over against future income. In effect, though cash might be lacking, the loss carry-over would furnish the purchase price. There is, therefore, no significant distinction between this situation and the group of cases in which other Courts of Appeals have disallowed a loss carry-over.

Petitioner's second argument for reversal of the Tax Court decision is wholly without substance. It is contended that the Commissioner is estopped to assert the deficiency by a prior favorable decision allowing the loss carry-over. But there was no such prior favorable determination by the Commissioner. A Revenue Agent (not the Commissioner), in the course of determining that the liquidating dividends paid by Consolidated would not be taxable as income to the recipients in the event of its continued existence, stated that loss carry-over available for subsequent years to 1952 totaled $3,150,582.26. This report was made in 1952, before any of the assets which produced the new income had been acquired. Thus, the facts of the case could not have been before the Agent. The statement was merely a summary of some mathematical calculations made in a different context and represented no determination whatever that the operating loss would be available to different shareholders to offset the profits of another business. Even if such a determination had been made, it would have been a mistake of law which would work no estoppel. *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180 (1957).

The decision of the Tax Court is affirmed.

II. JUDGMENT OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the twenty-eighth day of June one thousand nine hundred and sixty-three.

Present:

HON. STERRY R. WATERMAN,
HON. HENRY J. FRIENDLY,
HON. J. JOSEPH SMITH,
Circuit Judges

NORDEN KETAY CORPORATION (formerly Ketay Instrument Corporation), *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

Appeals from The Tax Court of the United States.

This cause came on to be heard on the transcript of record from The Tax Court of the United States, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is affirmed.

(SEAL)

A. DANIEL FUSARO, *Clerk*.
By VINCENT A. CARIAN
Chief Deputy Clerk

III. ORDERS OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT DENYING PETITIONS FOR REHEARING.

A. Order Denying Petition For Rehearing.

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

NORDEN-KETAY CORPORATION (formerly Ketay Instrument Corporation), *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION FOR REHEARING

DON V. HARRIS, JR. and COVINGTON & BURLING, Washington, D. C., for petitioner.

Petition denied.

S. R. W.
J. J. S.
U.S.C.J.J.

30 July 1963

B. Order Denying Petition For Rehearing In Banc.

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

NORDEN-KETAY CORPORATION (formerly Ketay Instrument Corporation), *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION FOR REHEARING IN BANC

DON V. HARRIS, JR. and COVINGTON & BURLING, Washington, D. C., for petitioner.

No active circuit judge having requested that the case be reheard in banc, the petition is denied.

J. EDWARD LUMBARD
Chief Judge

30 July 1963

IV. MEMORANDUM FINDINGS OF FACT AND OPINION OF THE TAX COURT OF THE UNITED STATES.

A. Headnote.

Petitioner corporation which had engaged for many years in a coal-mining business, sold all of its operating assets in 1951, and as a result thereof sustained a net operating loss in said year. Thereafter, said corporation acquired the stock of three other corporations which manufactured precision electronic components, dissolved said corporations, took over the assets and going businesses thereof, and continued to operate an electronics business throughout the taxable year. *Held*, that there was no "continuity of business enterprise" between the former mining business and the subsequent electronics business; and, accordingly, that petitioner is not entitled to carry over and deduct the 1951 net operating loss against its 1954 income realized in its new and different business of manufacturing electronic components. *Libson Shops, Inc.* v. *Koehler*, 353 U.S. 382, and *Hoaglin's*, 38 T.C. — (Aug. 30, 1962), followed.

B. Memorandum Findings of Fact and Opinion.

PIERCE, *Judge*:

The respondent determined a deficiency in petitioner's income tax for the calendar year 1954 in the amount of $30,033.33.

The basic question for decision is whether the petitioner, which had experienced substantial changes in the character of its business, its name, its place of operation, its management, and its capital structure—as the result of the discontinuance of its former business of mining coal, and its taking over a new type of business of manufacturing electronic components that had theretofore been operated by three other corporations—may under section 172 of the 1954 Code and section 122 of the 1939 Code, carry over and deduct from its 1954 income from such electronics business, a net operating loss sustained in 1951 in the former business of mining and selling coal.

Another issue relating to an adjustment which increased petitioner's net sales for 1954, was abandoned by petitioner at the trial by amending its petition so as to delete all references therein to said issue.

Findings of Fact

General Facts

Some of the facts were stipulated. The stipulation of facts, together with the exhibits identified therein, is incorporated herein by reference.

The petitioner is a dissolved Illinois corporation which, during the taxable calendar year 1954 here involved, had its principal place of business in New York City. It filed a corporation income tax return for said year with the district director of internal revenue for the Lower Manhattan District of New York.

The notice of deficiency herein was issued on May 12, 1959. The petitioner was thereafter dissolved on July 1, 1959. The petition to this Court was subsequently filed on August 7, 1959. Under the provisions of section 94 of the Business Corporation Act of the State of Illinois, petitioner was authorized to bring and maintain this action in its own name, despite its dissolution. No dispute is here involved regarding petitioner's right to conduct the present proceeding.

Petitioner was incorporated under the laws of the State of Illinois on July 20, 1886, under the name of "The Consolidated Coal Company of St. Louis." Its name was changed on February 20, 1935, to "The Consolidated Coal Company."[1] Thereafter, in connection with events and

[1] Hereinafter, when reference is made to the corporation in connection with events and transactions occurring when it bore the name of "The Consolidated Coal Company," said corporation will be referred to as "Consolidated."

transactions presently to be described, petitioner underwent other changes of name as follows: On April 15, 1953, its name was changed to "Ketay Manufacturing Corp."; on September 10, 1954, its name was changed to "Ketay Instrument Corporation"; and on February 11, 1955, its name was changed to "Norden-Ketay Corporation," which is the name it continued to bear until its above-mentioned dissolution, and under which it filed its petition herein.

Facts re Consolidated at and prior to sale of coal business assets in February 1951

The business of Consolidated from the time of its incorporation in 1886 until February 1951, was that of mining and selling bituminous coal. Its principal office while so engaged was in St. Louis, Missouri; but its extensive mining properties were located in the coal fields of southern Illinois. It also owned all of the outstanding capital stock of four subsidiary companies.[2] During the years 1949 and 1950, respectively, its net sales were $7,050,114.43 and $7,146,465.98, and its net incomes before Federal income taxes were $246,930.79 and $278,290.15. As of December 31, 1949 and 1950, its total assets were $8,952,848.95 and $9,086,818.39, respectively; and at said dates the amounts of its earned surplus were $7,174,985.05 and $3,243,275.20, respectively.

In the Fall of 1950, an attorney representing a decedent's estate which owned the largest single block of Consolidated's stock, approached the New York investment banking firm of Lehman Brothers, and suggested the possibility

[2] The record contains no definite evidence as to the types of business carried on by these subsidiaries. Perhaps some indications in this regard may be gleaned from the names of the subsidiaries: Consol Power Company, St. Louis, Missouri; Jefferson Southwestern Railroad Company, St. Louis, Missouri; Federal Coal Corporation, Chicago, Illinois; and Jefferson Oil and Gas Corporation, St. Louis, Missouri.

of said firm acquiring a controlling interest in said stock. Lehman Brothers was receptive to the suggestion; and thereupon it made arrangements with the Bankers Trust Company of New York to solicit (on behalf of Lehman Brothers, as undisclosed principal) options to purchase shares from the larger shareholders of Consolidated. After options covering approximately 94 percent of the Consolidated stock had thus been secured, Lehman Brothers began to search for a buyer of such stock in the event that it should decide to exercise such options. Following several unsuccessful attempts, Lehman Brothers did locate a potential purchaser, which was Zeigler Coal & Coke Company (hereinafter called Zeigler), an Illinois corporation engaged in operating coal mines in Illinois.

Lehman Brothers' desire was to sell the *stock* of Consolidated; and in its preliminary negotiations with Zeigler, an informal agreement was reached to sell the shares which it had under option at a price which would yield it a profit of $200,000. Later however, Zeigler indicated that it would be interested only in buying Consolidated's assets, and not the stock. Lehman Brothers thereupon advised that it would be agreeable to such a revised transaction, provided that it could realize the contemplated $200,000 profit, and provided also that it would not have to bear any expense that it would not bear if it sold the stock.

Lehman Brothers thereupon instructed its agent, the Bankers Trust Company, to exercise the options to purchase shares of Consolidated stock held on behalf of Lehman Brothers; and by February 28, 1951, the Trust Company had purchased 47,447 shares (or 94.7 percent of all the shares outstanding) on behalf of Lehman Brothers.

On February 26, 1951, Consolidated and Zeigler entered into an agreement of sale; and 2 days later, on February 28, 1951, Consolidated conveyed to Zeigler all of its assets except cash and United States Treasury obligations, and received in partial payment from Zeigler the sum of $2,900,

000 in cash. In addition to the cash thus paid by Zeigler, the corporation also agreed to pay over to Consolidated at later dates, 50 percent of the excess over $800,000 which Zeigler might receive upon its sale of certain so-called "disposable properties,"[1] received in the purchase from Consolidated.

Immediately upon receipt of the cash payment of $3,000,000 above mentioned, the directors of Consolidated declared and there was paid a "partial liquidating dividend" of $76.50 per share; and in May of 1951, the directors declared another "partial liquidating distribution" of $1.50 per share, which amount also was paid in the latter month. Lehman Brothers utilized said liquidating dividend and distribution (totalling $78 per share) which it thus received, for paying bank loans incurred by it in purchasing the shares of Consolidated, and also for paying certain brokerage commissions which it incurred in connection with said purchase.

In February 1954, a statement of intent to dissolve Consolidated was filed on behalf of that corporation with the Secretary of State of the State of Illinois. At no time after the above-described sale of operating assets to Zeigler did Consolidated ever conduct, manage, or operate a business of mining or selling coal.

Consolidated sustained a loss on the above-mentioned and above-described sale of its operating assets related to

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[1] The "disposable properties" which were assets of Consolidated that Zeigler did not plan or desire to retain, included all of the tangible assets of Consolidated which were situated in four Illinois counties, and also the capital stock of three of the four of Consolidated's subsidiary corporations. The $3,000,000 cash payment was sufficient only, when paid out to Consolidated's shareholders, to cover the out-of-pocket costs of Lehman Brothers. That firm had planned that its share of the proceeds from the sale of the "disposable properties" would constitute its profit on the purchase and sale of Consolidated stock.

coal mining in the amount of $3,509,043.55; and said corporation thereby sustained a net operating loss in said year 1951 in the amount of $3,466,387.52.

Facts re Consolidated following sale of coal business assets.

In the Spring of 1951, Lehman Brothers disposed of three blocks of its shares of Consolidated stock, as follows:

1. March 14, 1951, 4,447 shares were transferred to Emmanuel Becker, the attorney who had suggested to Lehman Brothers the acquisition of the Consolidated stock. Said shares were transferred at Consolidated's unrecovered cost of $1.50 per share, pursuant to an agreement between the attorney and Lehman Brothers, that the latter would give Becker 10 percent of any profit that Lehman Brothers might realize from the Consolidated stock transactions. The shares so transferred to Becker were intended to assure to Becker 10 percent of whatever profit Lehman Brothers might realize in final liquidation of Consolidated.

2. March 21, 1951, 2,372 shares were transferred to Paul Weir, a mining engineer and geologist, who had assisted Lehman Brothers in its search for a buyer for the Consolidated stock. These shares were likewise transferred at a price of $1.50 per share, pursuant to an agreement to share with him 5 percent of any profit which Lehman Brothers might realize on the Consolidated deal. These shares were subsequently reacquired by Consolidated in March or April, 1953.

3. April, 1951, 3,500 shares were transferred to Joseph H. McConnell, then president of the National Broadcasting Company, at $1.50 per share. The record herein does not reveal the reason for said transfer of shares to McConnell, other than it was made for reasons unrelated to the other transactions relevant to the present proceeding.

In June 1951, Consolidated's capital structure was altered, by reducing the par value of its stock from $100 per share to $1 per share, thus reducing its stated capital from $5,000,000 to $50,000.

During the interval from the sale of its assets to Zeigler on February 28, 1951, to the end of the year 1951, Consolidated was inactive. Zeigler hired two former employees of Consolidated to attend to collecting the accounts receivable, and to paying the accounts payable which Zeigler had purchased and assumed. Also, two of the directors of Consolidated had some correspondence with the president of Zeigler, wherein they urged that Zeigler proceed with greater speed to sell the above-mentioned "disposable properties," in the proceeds of which Consolidated was to share after the amount thereof had reached $800,000. By the end of the year 1951, Zeigler had realized approximately $790,000 from the sale of about 55 percent of such disposable properties.

Following the end of the year 1951, Zeigler made an offer to Consolidated to purchase the latter's interest in the disposable properties for $250,000. Consolidated accepted the offer, and on March 26, 1952, it entered into a "First Supplemental Agreement" with Zeigler, the here material provisions of which were, in substance, as follows:

> (1) Zeigler agreed to pay, and Consolidated agreed to accept, $250,000 in full settlement of the balance of the purchase price under the agreement between the two companies of February 26, 1951.
>
> (2) Consolidated agreed that upon receipt of the aforesaid sum of $250,000 it would "immediately take steps to dissolve" and that it would "complete its dissolution as quickly as may be reasonably possible."

The $250,000 mentioned in the foregoing agreement was paid by Zeigler to Consolidated immediately following execution of the same.

The officers of Consolidated, upon receipt of the above-mentioned $250,000, began to consider the possibility of not proceeding further with the dissolution of the corporation, but rather of having said corporation enter into some new type of business. Negotiations were thereupon undertaken by Consolidated with Zeigler to have that corporation waive the requirement that Consolidated be dissolved. About a year later, Zeigler and Consolidated entered into a "Second Supplemental Agreement" on April 2, 1953, wherein it was provided that Zeigler would waive the requirements that Consolidated be dissolved.

Five days later, on April 7, 1953, the stockholders of Consolidated adopted a resolution that the voluntary dissolution proceedings previously begun, should be revoked; and 2 days thereafter, on April 9, Consolidated filed with the Secretary of State of the State of Illinois a "Statement of Revocation of Dissolution Proceedings." Previously thereto, on March 30, 1953, said officials had issued a certificate that as of said date Consolidated was still in good standing as a domestic corporation of the State of Illinois.

During the interval between the above-mentioned March 1952 "First Supplemental Agreement" between Zeigler and Consolidated and the just-mentioned revocation of the dissolution proceedings, the officers of Consolidated conducted a search for some business which the corporation might buy. In this connection, sometime in the Fall of 1952, the officers of Consolidated began negotiations with an individual named Benjamin Gross, who represented the stockholders of a 3-member group of corporations, Ketay Manufacturing Corp., Kinetix Instrument Co., and Ketay Research & Development Co. (said three corporations are hereinafter referred to collectively as the "Ketay companies"), with a view to purchasing all the capital stocks of said three Ketay companies. The Ketay companies were at that time engaged in the business of developing, manufacturing, and selling precision electronic components.

These negotiations culminated in an agreement dated April 6, 1953, whereby Consolidated agreed to purchase all the outstanding shares of each of the three Ketay companies for a total consideration of $2,725,000, payable $100,000 in cash at the closing date, with the balance payable in installments on or before March 1, 1958. Said agreement was thereafter amended in one respect, viz., to increase the purchase price by $25,000. The purpose of buying said stock was to obtain the assets of the Ketay companies.

Concurrently with the execution of the stock purchase agreement of April 6, 1953, and as an integral part of the Ketay stock purchase transaction, Consolidated and the Ketay stockholders entered into a second agreement whereunder Consolidated agreed that it would increase the number of its authorized shares of capital stock from 50,000 to 75,000 and that it would issue and sell to the Ketay stockholders, warrants entitling them to purchase the additional 25,000 shares of Consolidated common stock at a price of $4.95 per share. The selling price of the warrants themselves was fixed at 5c for each share of stock covered thereby.

On April 9, 1953, Consolidated's articles of incorporation were amended in the following respects:

(1) Its corporate purposes were expanded to include the purposes of dealing in personal property and of engaging in manufacturing and mercantile enterprises;

(2) Its authorized shares of $1 per share common capital stock were increased from 50,000 to 75,000; and

(3) The preemptive right of shareholders to subscribe for or acquire additional shares was abrogated.

Thereafter, on April 15, 1953, closing took place under the aforesaid agreements between Consolidated and the Ketay stockholders; and Consolidated thereupon acquired all of the outstanding capital stock of each of the three

Ketay corporations. On the same day, immediately following Consolidated's purchase of the Ketay stocks, each of said Ketay companies filed with the Secretary of State of the State of New York its certificate of dissolution. Still on the same day, Consolidated changed its name to "Ketay Manufacturing Corp."[4] On the following day, April 16, the New York Secretary of State dissolved said three corporations. Consolidated-Ketay thereupon took over the going businesses, and became the owner of all of the assets and properties of the former Ketay companies; and it also assumed all of the liabilities of said companies. Consolidated-Ketay moved its principal office to New York City, and continuously thereafter engaged, until its own dissolution on July 1, 1959 (as hereinabove found as a fact), solely in the same business formerly carried on by the former Ketay companies, i.e., the development, manufacture and sale of precision electronic components.

Also on April 17, 1953, the stockholders of Consolidated-Ketay elected eight directors for the corporation, four of whom had been stockholders in the former Ketay companies.[5] Following this stockholders' meeting, the directors met and elected new officers for the corporation, including in various positions all those individuals who had been stockholders in the former Ketay companies. Said officers continued to serve throughout the taxable year 1954 here involved.

[4] As hereinabove found, the corporate name was subsequently changed on September 10, 1954, to "Ketay Instrument Corporation"; and its name was again changed on February 11, 1955, to "Norden-Ketay Corporation." Said corporation will be hereinafter referred to for convenience as "Consolidated-Ketay."

[5] At least three and possibly all four of the other directors were associated with Lehman Brothers, and they had been elected in February 1951, shortly prior to the sale of assets by Consolidated to Zeigler. None of the eight directors of Consolidated-Ketay had been associated with Consolidated during the years when it operated the coal-mining business.

Subsequently, on August 15, 1953, all of the above-described stock warrants which had been issued to the former Ketay stockholders, were exercised by said individuals or by other parties to whom such individuals had transferred or assigned the same.

The capital structure of Consolidated-Ketay was subsequently changed in the following respects:

(1) On November 2, 1953, the authorized common capital stock was changed and increased from 75,000 shares, having a par value of $1 per share, to 850,000 shares having a par value of 10¢ per share; and said 75,000 shares of $1 par-value stock were split 10 for 1, and reclassified and changed into 750,000 shares having a par value of 10¢ per share.

(2) On June 22, 1954, the authorized common capital stock was further increased from 850,000 shares, par value of 10¢ per share, to 2,000,000 shares, par value of 10¢ per share. On September 29, 1954, 300,000 of the newly authorized shares were sold to underwriters for subsequent sale to the members of the public.

Consolidated-Ketay, on the Federal income tax return which it filed for the taxable calendar year 1954 here involved, reported taxable income from its electronics business of $1,007,623.38, before net operating loss deduction. On this same return it carried over from the year 1951 a net operating loss of $2,304,125.58 which had resulted principally from the sale of the assets of the coal-mining business; and it claimed such operating loss as a deduction—thereby reporting loss on the return for 1954 in the amount of $1,296,502.20.

The respondent, in his notice of deficiency herein, disallowed said claimed net operating loss deduction.

OPINION

The basic issue in this case is, as above stated, whether the petitioner is entitled to carry over and deduct against its 1954 income from a business of manufacturing electronic components, a net operating loss sustained by the same corporate entity in 1951 when it, as a coal-mining company, disposed of the operating assets of the coal-mining business which it had theretofore conducted.

We have, only recently, considered a similar question in the case of *Hunler's*, 38 T.C. — (Aug. 30, 1962). We there held, applying the "continuity of business enterprise" principle enunciated by the Supreme Court in *Libson Shops, Inc.* v. *Koehler*, 353 U.S. 382, that a taxpayer-corporation which had experienced substantial changes in its stock ownership and in the character of its business, could not carry over and deduct from its income of years following such changes, net operating losses sustained in its former business prior to the changes. There are, of course, factual distinctions between the *Hunler's* case and the instant case. For example, Huyler's went from a business of manufacturing candy and operating a chain of restaurants to a business of manufacturing aluminum products; while here, the petitioner's original business was that of mining and selling coal, and its subsequent business (as it existed in the taxable year for which the deduction involved was claimed) was that of manufacturing precision electronic components. Also, in *Hunler's*, there was a Chapter X bankruptcy reorganization, while here there was no reorganization. But these are mere distinctions, without any real underlying differences of legal principle which would call for a different result here. In the instant case, in the interval between the year (1951) when the net operating loss here involved was sustained and the year (1954) in which petitioner has sought to carry over and deduct said loss, there were radical changes in the business enterprise involved—including changes in the capital structure of the

business, in the location of the business, in the management of the business, in the stock ownership of the business, in the type of the business and its products, and even in the name of the business. We are impelled to conclude in such circumstances, that the 1954 income was not produced from substantially the same business as that which produced the 1951 loss; and hence, that there was no "continuity of business enterprise," as that phrase is used in the *Libson Shops* case and as it has been construed and applied by this and other courts in: *Huyler's, supra; K. G. Dudley, Inc.*, 36 T.C. 1122, affd. (C.A. 4) 298 F. 2d 750; *Mill Ridge Coal Co. v. Patterson*, (C.A. 5) 264 F. 2d 713, certiorari denied 361 U.S. 816; and *Willingham v. United States*, (C.A. 5) 298 F. 2d 283.

Since the conclusion which we have above set forth is dispositive of this case, we find it unnecessary to discuss the other contentions which petitioner presented.

We hold that deduction by petitioner of the net operating loss here involved is not allowable. We sustain the determination of the Commissioner in this regard.

Decision will be entered for the respondent.

V. ORDER AND DECISION OF THE TAX COURT OF THE UNITED STATES.

"DECISION

"Pursuant to the Determination of the Court, as set forth in its Memorandum Findings of Fact and Opinion filed October 23, 1962, it is

"ORDERED AND DECIDED: That there is a deficiency in income tax for the calendar year 1954 in the amount of $630,033.33.

"(Signed) ALLEN H. PIERCE
Judge"

"ENTER:

"ENTERED Oct. 24, 1962"

VI. STATUTES INVOLVED.

A. Allowance of Petitioner's Net Operating Loss.

1. Application of the Internal Revenue Codes of 1939 and 1954.

It is not contested that Petitioner had a net operating loss for the calendar year 1951.

To the extent that said loss was not absorbed against Petitioner's profits for 1950 and 1953, as set forth in the stipulated figures, that loss is allowed to Petitioner as a deduction for the calendar year 1954 under Section 172(a) of the Internal Revenue Code of 1954.

Section 172 of the Internal Revenue Code of 1954 is a part of Subtitle A, Chapter 1, Subchapter B, Part VI, of said Code. Under Section 7851(a)(1)(A) of said Code, 26 U.S.C. § 7851(a)(1)(A) (1958 ed.), 68A Stat. 919, Aug. 16, 1954, said Section 172 is applicable with respect to taxable years beginning after December 31, 1953, and ending after August 16, 1954. The calendar year 1954 is such a year. The allowance of the loss on the 1954 return is, therefore, pursuant to Section 172 of the 1954 Code.

The computation of the amount of the loss which arose in 1951, and the computations of the amounts of said loss absorbed by carryback to 1950 and carryover to 1953, are made under the law applicable to each said year, Section 172(e) of the Internal Revenue Code of 1954. These figures are stipulated.

The determination of the years to which a loss for the calendar year 1951 may be carried is made under the applicable provisions of the Internal Revenue Code of 1939. Section 172(g)(1) of the Internal Revenue Code of 1954. Petitioner's 1951 loss which may be carried forward to 1954 is stipulated.

Petitioner had an excess of deductions over gross income for 1951, in the stipulated amount, which was a net operat-

ing loss under Section 122(a) of the Internal Revenue Code of 1939, 26 U.S.C. § 122(a) (1952 ed.), 53 Stat. 867, June 29, 1939, 56 Stat. 807, October 21, 1942. Such loss was first a carryback to 1950 under Section 122(b)(1)(B) of the Internal Revenue Code of 1939; 26 U.S.C. § 122(b)(1)(B) (1952 ed.), 53 Stat. 867, June 29, 1939, 56 Stat. 847, 848, October 21, 1942, 64 Stat. 938, September 23, 1950. The unused portion of said loss was thereafter a carryover for each of the five taxable years succeeding 1951, under Section 122(b)(2)(B) of the Internal Revenue Code of 1939, 26 U.S.C. § 122(b)(2)(B) (1952 ed.), 53 Stat. 867, June 29, 1939, 56 Stat. 847, 848, October 21, 1942, 64 Stat. 938, September 23, 1950. The required "exceptions, additions, and limitations" have been taken into account in the stipulated figures.

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2. *Text of Section 172 of the Internal Revenue Code of 1954, as in Effect for the Calendar year 1954, Including Retroactive Amendments by Pub. L. 85-866.*

SEC. 172. NET OPERATING LOSS DEDUCTION.

(a) Deduction Allowed.—There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year. For purposes of this subtitle, the term "net operating loss deduction" means the deduction allowed by this subsection.

(b) Net Operating Loss Carrybacks and Carryovers.—

(1) Years to Which Loss May Be Carried.—A net operating loss for any taxable year ending after December 31, 1953, shall be—

(A) a net operating loss carryback to each of the 2 taxable years preceding the taxable year of such loss, and

(B) a net operating loss carryover to each of the 5 taxable years following the taxable year of such loss.

(2) Amount of Carrybacks and Carryovers.—Except as provided in subsection (f), the entire amount of the net operating loss for any taxable year (hereinafter in this section referred to as the "loss year") shall be carried to the earliest of the 7 taxable years to which (by reason of subparagraphs (A) and (B) of paragraph (1)) such loss may be carried. The portion of such loss which shall be carried to each of the other 6 taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried. For purposes of the preceding sentence, the taxable income for any such prior taxable year shall be computed—

(A) with the modifications specified in subsection (d) other than paragraphs (1), (4), and (6) thereof; and

(B) by determining the amount of the net operating loss deduction without regard to the net operating loss for the loss year or for any taxable year thereafter,

and the taxable income so computed shall not be considered to be less than zero.

(c) Net Operating Loss Defined.—For purposes of this section, the term "net operating loss" means (for any taxable year ending after December 31, 1953) the excess of the deductions allowed by this chapter over the gross income. Such excess shall be computed with the modifications specified in subsection (d).

(d) Modifications.—The modifications referred to in this section are as follows:

(1) Net Operating Loss Deductions.—No net operating loss deduction shall be allowed.

(2) Capital Gains and Losses of Taxpayers Other Than Corporations.—In the case of a taxpayer other than a corporation—

(A) the amount deductible on account of losses from sales or exchanges of capital assets shall not exceed the amount includible on account of gains from sales or exchanges of capital assets; and

(B) the deduction for long-term capital gains provided by section 1202 shall not be allowed.

(3) Deductions for Personal Exemptions.—No deduction shall be allowed under section 151 (relating to personal exemptions). No deduction in lieu of any such deduction shall be allowed.

(4) Nonbusiness Deductions of Taxpayers Other Than Corporations.—In the case of a taxpayer other than a corporation, the deductions allowable by this chapter which are not attributable to a taxpayer's trade or business shall be allowed only to the extent of the amount of the gross income not derived from such trade or business. For purposes of the preceding sentence—

(A) any gain or loss from the sale or other disposition of—

(i) property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or

(ii) real property used in the trade or business,

shall be treated as attributable to the trade or business;

(B) the modifications specified in paragraphs (1), (2)(B), and (3) shall be taken into account; and

(C) any deduction allowable under section 165 (g)(3) (relating to casualty losses) shall not be taken into account.

(5) Special Deductions for Corporations.—No deduction shall be allowed under section 242 (relating to partially tax-exempt interest) or under section 922 (relating to Western Hemisphere trade corporations).

(6) Computations of Deductions for Dividends Received, etc.—The deductions allowed by sections 243 (relating to dividends received by corporations), 244 (relating to dividends received on certain preferred stock of public utilities), and 245 (relating to dividends received from certain foreign corporations) shall be computed without regard to section 246(b) (relating to limitation on aggregate amount of deductions); and the deduction allowed by section 247 (relating to dividends paid on certain preferred stock of public utilities) shall be computed without regard to subsection (a)(1)(B) of such section.

(e) Law Applicable to Computations.—In determining the amount of any net operating loss carryback or carryover to any taxable year, the necessary computations involving any other taxable year shall be made under the law applicable to such other taxable year. The preceding sentence shall apply with respect to all taxable years, whether they begin before, on, or after January 1, 1954.

(f) Taxable Years Beginning in 1953 and Ending in 1954.—In the case of a taxable year beginning in 1953 and ending in 1954—

(1) In lieu of the amount specified in subsection (c), the net operating loss for such year shall be the sum of—

(A) that portion of the net operating loss for such year computed without regard to this subsection

which the number of days in the loss year after December 31, 1953, bears to the total number of days in such year, and

(B) that portion of the net operating loss for such year computed under section 122 of the Internal Revenue Code of 1939 as if this section had not been enacted which the number of days in the loss year before January 1, 1954, bears to the total number of days in such year.

(2) The amount of any net operating loss for such year which shall be carried to the second preceding taxable year is the amount which bears the same ratio to such net operating loss as the number of days in the loss year after December 31, 1953, bears to the total number of days in such year. In determining the amount carried to any other taxable year, the reduction for the second taxable year preceding the loss year shall not exceed the portion of the net operating loss which is carried to the second preceding taxable year.

(3) The net operating loss deduction for such year shall be, in lieu of the amount specified in section 122(c) of the Internal Revenue Code of 1939, the sum of—

(A) that portion of the net operating loss deduction for such year, computed as if subsection (a) of this section were applicable to the taxable year, which the number of days in such year after December 31, 1953, bears to the total number of days in such year, and

(B) that portion of the net operating loss deduction for such year, computed under section 122(c) of the Internal Revenue Code of 1939 as if this paragraph had not been enacted, which the number of days in such year before January 1, 1954, bears to the total number of days in such year.

(4) For purposes of the second sentence of subsection (b)(2), the taxable income for such year shall be the sum of—

(A) that portion of the net income for such year, computed without regard to this paragraph, which the number of days in such year before January 1, 1954, bears to the total number of days in such year, and

(B) that portion of the net income for such year, computed—

(i) without regard to paragraphs (1) and (2) of section 122(d) of the Internal Revenue Code of 1939, and

(ii) by allowing as a deduction an amount equal to the sum of the credits provided in subsections (b) and (h) of section 26 of such Code,

which the number of days in such year after December 31, 1953, bears to the total number of days in such year.

(g) Special Transitional Rules.—

(1) Losses for Taxable Years Ending Before January 1, 1954.—For purposes of this section, the determination of the taxable years ending after December 31, 1953, to which a net operating loss for any taxable year ending before January 1, 1954, may be carried shall be made under the Internal Revenue Code of 1939.

(2) Losses for Taxable Years Ending After December 31, 1953.—For purposes of section 122 of the Internal Revenue Code of 1939—

(A) the determination of the taxable years ending before January 1, 1954, to which a net operating loss

for any taxable year ending after December 31, 1953, may be carried shall be made under subsection (b) (1) (A) of this section; and

(B) in determining the amount of the carryback to the first taxable year preceding the first taxable year ending after December 31, 1953, the portion of the net operating loss carried to such year shall be such net operating loss reduced by—

(i) the net income for the second preceding taxable year computed as if the second sentence of section 122(b)(2)(B) of the Internal Revenue Code of 1939 applied, or

(ii) if smaller, the portion of the net operating loss which by reason of subsection (f) of this section is carried to the second preceding taxable year.

(3) Taxable Years Beginning After December 31, 1953, and Ending Before August 17, 1954.—In the case of a taxable year which begins after December 31, 1953, and ends before August 17, 1954—

(A) the net operating loss deduction for such year shall be computed as if subsection (a) of this section applied to such taxable year; and

(B) for purposes of the second sentence of subsection (b)(2), the taxable income for such taxable year shall be the net income for such taxable year, computed—

(i) without regard to paragraphs (1) and (2) of section 122(d) of the Internal Revenue Code of 1939, and

(ii) by allowing as a deduction an amount equal to the sum of the credits provided in subsections (b) and (h) of section 26 of such Code.

(4) Excess Profits Tax Not Affected.—For purposes of subchapter D of chapter 1 of the Internal Revenue Code of 1939, excess profits net income shall be computed as if this section had not been enacted and as if section 122 of such Code continued to apply to taxable years to which this subtitle applies.

(h) Cross References.—

(1) For treatment of net operating loss carryovers in certain corporate acquisitions, see section 381.

(2) For special limitation on net operating loss carryovers in case of a corporate change of ownership, see section 382.

B. Section 129 of the Internal Revenue Code of 1939 and Section 269 of the Internal Revenue Code of 1954.

1. *Effective Dates.*

Section 129 is applicable to acquisitions made on or after October 8, 1940, and to taxable years beginning after December 31, 1943, but was repealed as to taxable years beginning after December 31, 1953 and ending after August 16, 1954. Section 269 applies to acquisitions made on or after October 8, 1940, and to taxable years beginning after December 31, 1953, and ending after August 16, 1954.

2. *Text of Section 129 of the Internal Revenue Code of 1939.*

SEC. 129. ACQUISITIONS MADE TO EVADE OR AVOID INCOME OR EXCESS PROFITS TAX.

(a) Disallowance of deduction, credit, or allowance. If (1) any person or persons acquire, on or after October 8, 1940, directly or indirectly, control of a corporation, or (2) any corporation acquires, on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately prior to such acquisition, by such acquiring corporation

or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation, and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income or excess profits tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed. For the purposes of clauses (1) and (2), control means the ownership of stock possessing at least 50 per centum of the total combined voting power of all classes of stock entitled to vote or at least 50 per centum of the total value of shares of all classes of stock of the corporation.

(b) Power of Commissioner to allow deduction, etc., in part. In any case to which subsection (a) is applicable the Commissioner is authorized—

(1) to allow as a deduction, credit, or allowance any part of any amount disallowed by such subsection, if he determines that such allowance will not result in the evasion or avoidance of Federal income and excess profits tax for which the acquisition was made; or

(2) to distribute, apportion, or allocate gross income, and distribute, apportion, or allocate the deductions, credits, or allowances the benefit of which was sought to be secured, between or among the corporations, or properties, or parts thereof, involved, and to allow such deductions, credits, or allowances so distributed, apportioned, or allocated; but to give effect to such allowance only to such extent as he determines will not result in the evasion or avoidance of Federal income and excess profits tax for which the acquisition was made; or

(3) to exercise his powers in part under paragraph (1) and in part under paragraph (2).

3. Text of Section 269 of the Internal Revenue Code of 1954.

SEC. 269. ACQUISITIONS MADE TO EVADE OR AVOID INCOME TAX.

(a) In General.—If—

(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

(2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation,

and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed. For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

(b) Power of Secretary or His Delegate To Allow Deduction, etc., In Part.—In any case to which subsection (a) applies the Secretary or his delegate is authorized—

(1) to allow as a deduction, credit, or allowance any part of any amount disallowed by such subsection, if he determines that such allowance will not result in the evasion or avoidance of Federal income tax for which the acquisition was made; or

(2) to distribute, apportion, or allocate gross income, and distribute, apportion, or allocate the deductions, credits, or allowances the benefit of which was sought to be secured, between or among the corporations, or properties, or parts thereof, involved, and to allow such deductions, credits, or allowances so distributed, apportioned, or allocated, but to give effect to such allowance only to such extent as he determines will not result in the evasion or avoidance of Federal income tax for which the acquisition was made; or

(3) to exercise his powers in part under paragraph (1) and in part under paragraph (2).

(c) Presumption in Case of Disproportionate Purchase Price.—The fact that the consideration paid upon an acquisition by any person or corporation described in subsection (a) is substantially disproportionate to the aggregate—

(1) of the adjusted basis of the property of the corporation (to the extent attributable to the interest acquired specified in paragraph (1) of subsection (a)), or of the property acquired specified in paragraph (2) of subsection (a); and

(2) of the tax benefits (to the extent not reflected in the adjusted basis of the property) not available to such person or corporation otherwise than as a result of such acquisition,

shall be prima facie evidence of the principal purpose of evasion or avoidance of Federal income tax. This subsection shall apply only with respect to acquisitions after March 1, 1954.

C. Section 382 of the Internal Revenue Code of 1954.

1. *Effective Date:*

Subsection 382(a) generally applies to taxable years beginning after December 31, 1953, and ending after August 16, 1954, but Subsection 382(a) is only applicable with re-

spect to changes in stock ownership occurring on or after June 22, 1954."

2. *Text of Subsection 382(a) of the Internal Revenue Code of 1954:*

SEC. 382. SPECIAL LIMITATIONS ON NET OPERATING LOSS CARRYOVERS.

(a) Purchase of a Corporation and Change in Its Trade or Business.—

(1) In General.—If, at the end of a taxable year of a corporation—

(A) any one or more of those persons described in paragraph (2) own a percentage of the total fair market value of the outstanding stock of such corporation which is at least 50 percentage points more than such person or persons owned at—

(i) the beginning of such taxable year, or

(ii) the beginning of the prior taxable year,

(B) the increase in percentage points at the end of such taxable year is attributable to—

(i) a purchase by such person or persons of such stock, the stock of another corporation owning stock in such corporation, or an interest in a partnership or trust owning stock in such corporation, or

(ii) a decrease in the amount of such stock outstanding or the amount of stock outstanding of another corporation owning stock in such corporation, except a decrease resulting from a redemption to pay death taxes to which section 303 applies, and

(C) such corporation has not continued to carry on a trade or business substantially the same as

that conducted before any change in the percentage ownership of the fair market value of such stock,

the net operating loss carryovers, if any, from prior taxable years of such corporation to such taxable year and subsequent taxable years shall not be included in the net operating loss deduction for such taxable year and subsequent taxable years.

(2) Description of Person or Persons.—The person or persons referred to in paragraph (1) shall be the 10 persons (or such lesser number as there are persons owning the outstanding stock at the end of such taxable year) who own the greatest percentage of the fair market value of such stock at the end of such taxable year; except that, if any other person owns the same percentage of such stock at such time as is owned by one of the 10 persons, such person shall also be included. If any of the persons are so related that such stock owned by one is attributed to the other under the rules specified in paragraph (3), such persons shall be considered as only one person solely for the purpose of selecting the 10 persons (more or less) who own the greatest percentage of the fair market value of such outstanding stock.

(3) Attribution of Ownership.—Section 318 (relating to constructive ownership of stock) shall apply in determining the ownership of stock, except that section 318(a)(2)(C) shall be applied without regard to the 50 percent limitation contained therein.

(4) Definition of Purchase.—For purposes of this subsection, the term "purchase" means the acquisition of stock, the basis of which is determined solely by reference to its cost to the holder thereof, in a transaction from a person or persons other than the person or persons the ownership of whose stock would be attributed to the holder by application of paragraph (3).

VII. PERTINENT REVENUE RULINGS.

A. Text of Revenue Ruling 58-603, 1958-2 Cum. Bull. 147

In Libson Shops, Inc., v. *Koehler*, 353 U. S. 382, Ct. D. 1809, C. B. 1957-2, 891, the Supreme Court of the United States announced the principle that, under the Internal Revenue Code of 1939, a surviving corporation in a merger may not carry over and deduct pre-merger net operating losses of one business against post-merger income of another business which was operated and taxed separately before the merger. The principle announced in that case will not be relied upon by the Internal Revenue Service under the Internal Revenue Code of 1954 as to a merger or any other transaction described in section 381(a) of the 1954 Code. However, see sections 382(b) and 269 of the 1954 Code for the possible disallowance of net operating loss carryovers in such transactions, and see the Income Tax Regulations under section 368 of the 1954 Code for the Requirements of a reorganization.

B. Text of Revenue Ruling 59-395, 1959-2 Cum. Bull. 475

In view of the decision of the Supreme Court of the United States in *Libson Shops, Inc.* v. *Koehler*, 353 U.S. 382, Ct. D. 1809, C. B. 1957-2, 891, consideration has been given the extent to which net operating losses or unused excess profits credits may be carried back or carried over across the line of the corporate fusion after a statutory merger or consolidation the tax treatment of which is determined under the provisions of the Internal Revenue Code of 1939.

In the *Libson Shops* case, *supra*, there were involved 17 corporations, all chartered in 1946 and all owned directly or indirectly by the same individuals in the same proportions. Of the 17 corporations one was a management corporation and the remainder were operating corporations. After incorporation in 1946, each of the operating corporations was conducted separately and filed separate Federal

income tax returns. In 1949, the operating corporations were merged under state law into the management corporation. The name of the former management corporation was then changed; the amount and pay value of its stock were revised; new shares of capital stock were issued pro rata in exchange for the capital stock of the operating corporations; and the businesses of the management and the operating corporations were merged into a single enterprise which filed a single Federal income tax return.

In the taxable year prior to the merger, three of the operating corporations sustained net operating losses and in the year following the merger each of the units formerly operated by those corporations sustained a net operating loss. In its Federal income tax return for the first year following the merger, the resultant corporation claimed the premerger net operating losses of the units in question as a deduction under sections 23(s) and 122 of the Internal Revenue Code of 1939. Upon examination of the return the Commissioner of Internal Revenue disallowed such claimed deduction. The disallowance was sustained by the United States District Court for the Eastern District of Missouri, affirmed by the Court of Appeals for the Eighth Circuit, and finally by the Supreme Court of the United States.

In its decision in the *Libson Shops* case, *supra*, the Supreme Court took the position that the issue involved centered on the meaning of the phrase "the taxpayer" as used in the statute; that the contentions of the parties required a decision on whether the corporation resulting from the merger involved was "the taxpayer" having the premerger losses; that, for purposes of the net operating loss carryover privilege, the resultant corporation involved the same "taxpayer" as the corporation which prior to the merger sustained the losses only as there was continuity, in the resultant corporation, of substantially the same business enterprise which prior to the merger sustained the

loss; and that, even where there was such a continuity of business enterprise in the resultant corporation, the latter was the same taxpayer as the loss corporation only to the extent that the loss carried over from a premerger year of such loss corporation offset that part of the income of the resultant corporation which was derived from the operation of substantially the same business enterprise which prior to the merger sustained the loss.

The Court observed further that the stated requirement of continuity of business enterprise is in accord with the legislative history of the carry-over and carryback provisions of the 1939 Code; that the availability of the carry-over privilege depends upon the proper interpretation being given to the net operating loss provisions of the Code; that those provisions were enacted to ameliorate the unduly drastic consequences of taxing income on an annual basis and were designed to permit a taxpayer to set off lean years against lush ones and to strike something like an average taxable income computed over a period longer than one year; that there is no indication in the legislative history that the provisions were designed to permit the averaging of the premerger losses of one business with the postmerger income of some other business operated and taxed separately before the merger; that nothing found in such provisions suggested that they should be so construed as to give a "windfall" to a taxpayer who happened to have merged with other corporations; that the purpose of the provisions is not to give a merged taxpayer an advantage over others who have not merged; and that what history there is suggests that Congress primarily was concerned with the fluctuating income of a single business.

The Court noted that the distinctions indicated had already been recognized in the decisions of the courts; that in *Stanton Brewery, Inc. v. Commissioner*, 176 Fed. (2d) 573, in which a carry-over of an unused excess profits credit across the line of a statutory merger was allowed, the

merging corporations carried on essentially a continuing enterprise; that in *Newmarket Manufacturing Company* v. *United States*, 233 Fed. (2d) 493, certiorari denied in 353 U.S. 983, in which a carry-back of a net operating loss across the line of a statutory merger was permitted, a single business was involved; and that in *Koppers Company* v. *United States*, 134 Fed. Supp. 290, certiorari denied, 353 U.S. 983, in which a carry-back of an unused excess profits credit across the line of a statutory merger was allowed, the resultant corporation conducted essentially the same taxable enterprise as was previously carried on since the merged group had previously filed consolidated returns.

Commenting that the difference involved was not merely a "matter of form" the Court observed that, in the *Libson Shops* case, had there been no merger, the three businesses which, prior to the merger, sustained losses would have had no opportunity to carry over such losses since in the succeeding year they had no income; that, had the resultant corporation been permitted to carry over such losses, the 16 businesses included in the resultant corporation would have acquired by merger an opportunity to receive the benefit of a carry-over to which they would not otherwise have been entitled; and that the fact that no question of tax evasion or avoidance, within the purview of section 129 of the 1939 Code, was involved did not mean that following a merger the resultant corporation was automatically entitled to a carry-over of a premerger loss of a constituent.

Since, therefore, in the *Libson Shops* case, the income of the resultant corporation against which the premerger losses were sought to be offset was not produced by substantially the same businesses which produced the losses, the Court concluded that the resultant corporation was not entitled to a carry-over of such losses across the line of the merger.

While on the basis of the particular facts before it in the *Libson* case a carry-over of a net operating loss was there denied, it is the opinion of the Internal Revenue Service that, in view of the principles enunciated and the decisions cited by the Court in that case, a different result would be warranted under the 1939 Code where a carry-over across the line of a statutory merger would result in application of either the premerger losses or unused excess profits credits of an absorbed constituent corporation to offset income derived by the resultant corporation from the same business by which the loss was sustained or the credit acquired. For the same reasons, carry-backs of net operating losses and unused excess profits credits of the resultant corporation attributable to absorbed constituent corporations would appear to be properly allowable, to the extent that they offset premerger income of such constituent corporations, in determining the tax liability to which the resultant corporation has succeeded. These conclusions would seem also to be applicable with respect to consolidations. See *Helvering* v. *Metropolitan Edison Company*, 306 U.S. 522, Ct. D. 1392, C.B. 1939-1 (Part 1), 229, in which, and in cases referred to therein, carry-overs of tax rights across the line of statutory corporate fusions were allowed without apparent regard to whether such statutory fusions were mergers or consolidations.

From the comment of the Court in the *Libson Shops* case, it would appear also that where, following a year in which a group of corporations has properly filed a consolidated return, such group of corporations undergoes a statutory merger or consolidation, and thereafter the resultant corporation conducts the same businesses previously operated by the constituents, the constituent corporations which prior to the merger or consolidations filed a consolidated return are to be regarded as representing collectively, after the merger or consolidation, the same taxable enterprise as before that event.

Accordingly, absent any evasion or avoidance of tax within the purview of section 129 or other provisions of the 1939 Code, with respect to statutory mergers and consolidations the tax treatment of which is determined under such Code, it is held that (1) following a statutory merger or consolidation, the premerger or preconsolidation net operating losses and unused excess profits credits of an absorbed constituent corporation may be carried over to the resultant corporation to the extent that such losses and unused excess profits credits offset income of the resultant corporation attributable to assets acquired by it from the absorbed constituent and used in continuing the prefusion business of such absorbed constituent; (2) the portion of the net operating losses and unused excess profits credits attributable to the assets acquired by the resultant corporation from an absorbed constituent and used in continuing the prefusion business of such absorbed constituent may be carried back, to the extent that they offset the prefusion income of the absorbed constituent, in determining the tax liability to which the resultant corporation has succeeded; and (3) where, following a year in which a group of corporations properly filed a consolidated return, such group undergoes a statutory merger or consolidation and thereafter the resultant corporation conducts the same businesses as previously operated by the constituent corporations, carry-overs and carry-backs of net operating losses and unused excess profits credits across the line of the fusion are allowable on the same basis as if the group of constituent corporations which, before the merger or consolidation filed consolidated returns, represents, collectively, after the merger or consolidation the same taxable enterprise as before that event.

Notwithstanding the foregoing, it is also held that under the 1939 Code, carry-overs and carry-backs of net operating losses and unused excess profits credits across the line of corporate fusions and successions effected other than by statutory merger or consolidation are not allowable. See

New Colonial Ice Company, Inc. v. *Helvering*, 292 U.S. 435, Ct. D. 841, XIII-1, 194, at 197 (1934), wherein, noting that the corporate merger there involved was not affected by operation of law, the Court held that a net operating loss carry-over was not allowable to the successor corporation and that this was so notwithstanding the fact that all the assets and the business of the older corporation were taken over by a new corporation, specially organized for the purpose and having substantially the same capital structure, in exchange for a portion of the stock of the new corporation which was distributed by the older corporation to the latter's stockholders share for share, thereby retiring the old shares.

Further, the taxpayer has the burden of establishing the correctness of the amount claimed as a net operating loss deduction or unused excess profits credit. Even after a statutory merger or consolidation subject to the 1939 Code, if the records of the resultant corporation are not maintained in such manner as to enable the Internal Revenue Service to make a reasonably conclusive determination as to the part of such deduction or credit allocable to the portion of the business of the resultant corporation conducted with the assets of the merged constituent, the claim will be regarded as having failed for lack of proof and will be disallowed.

The conclusions hereinbefore reached are directed generally to the effect of the *Libson Shops* decision on carryovers and carrybacks of net operating losses and unused excess profits credits across the line of statutory mergers or consolidations effected pursuant to the provisions of the 1939 Code. However, even though the merger or consolidation itself has been consummated prior to the effective date of the Internal Revenue Code of 1954, carryover and carrybacks across the line of such effective date are not to be regarded as permissible where their allowance would be in contravention of sections 172, 381, 382, 269, or other

provisions of the 1954 Code. Further, the principle announced in the *Libson Shops* case, under the 1939 Code, to the effect that a surviving corporation in a merger may not carry over and deduct pre-merger net operating losses of one business against post-merger income of another business operated and taxed separately before the merger, will not be relied upon by the Service as to a merger or any other transaction described in section 381(a) of the 1954 Code. But see sections 382(b) and 269 of the 1954 Code for the possible disallowance of net operating loss carryovers in such transactions, and see the regulations under section 368 of the 1954 Code for the requirements of a reorganization. See also Revenue Ruling 58-603, C.B. 1958-2, 147.

C. Text of Revenue Ruling 63-40, 1963-12 Int. Rev. Bull. 8.

Advice has been requested whether either the rationale of the decision in *Libson Shops, Inc.* v. *Koehler*, 353 U.S. 382 (1957), Ct. D. 1809, C.B. 1957-2, 891, or the provisions of section 269 of the Internal Revenue Code of 1954 prevent the use of a net operating loss carryover under the circumstances described below.

1. The *M* corporation was organized in 1947 by three individuals who owned an equal number of shares of its authorized and outstanding stock. From the date of its incorporation until the early part of 1958 it was engaged in the fabrication and sale, through distributors, of household light steel products. The business was successful during its early years of operation. However, commencing in 1953 it sustained losses in each of its taxable years and over the period ending December 31, 1957, had accumulated substantial net operating losses.

In 1958 *M* corporation purchased for cash, at fair market value, all of the assets of *N* corporation, which had a history of successful operation of drive-in restaurants. *M* and *N* were unrelated corporations and none of the

shareholders of *M* corporation owned, directly or indirectly, any stock of *N* corporation. The funds for the cash purchase were derived in part from *M* corporation's own business assets and in part from an equal contribution to its capital of cash by its three stockholders. Shortly thereafter, *M* corporation discontinued its former business activity, sold the assets connected therewith, and engaged exclusively in the business of operating the chain of drive-in restaurants formerly operated by the *N* corporation.

Under the facts presented, neither section 269 nor section 382 of the Code is applicable and the sole question raised is whether the rationale of the *Libson Shops* decision bars the allowance of the net operating loss deduction attributable to losses incurred prior to the acquisition of the new business activity for *M* corporation's taxable year ended December 31, 1958.

In cases like the one discussed above, arising under section 122 of the Internal Revenue Code of 1939 or section 172 of the 1954 Code in which losses have been incurred by a single corporation and there has been little or no change in the stock ownership of the corporation during or after the period in which the losses were incurred, the Internal Revenue Service will not rely on the rationale of the *Libson Shops* decision to bar the corporation from using losses previously incurred by it solely because such losses are attributable to a discontinued corporate activity. Accordingly, since there was no change in stock ownership in *M* corporation either before the discontinuance of its former business activity or after the commencement of its new business activity, a net operating loss deduction is allowable for its taxable year ended December 31, 1958.

However, if there is more than a minor change in stock ownership of a loss corporation which acquires a new business enterprise, the Service may continue to contest the deductibility of the carryover of the corporation's prior losses against income of the new business enterprise. See,

for example, as involving substantial changes in stock ownership. *Milk Ridge Coal Co.* v. *Patterson*, 264 Fed. (2d) 713 (1959), certiorari denied, 361 U.S. 816 (1959); *A. C. Willingham* v. *United States*, 289 Fed. (2d) 283 (1961), certiorari denied, 368 U.S. 828 (1961); *Commissioner* v. *Virginia Metal Products, Inc.*, 290 Fed. (2d) 675 (1961), certiorari denied, 368 U.S. 889 (1961); *J. G. Dudley Co., Inc.* v. *Commissioner*, 298 Fed (2d) 750 (1962); and *Hugler's* v. *Commissioner*, 38 T.C. 773 (1962). Compare *Kolker Bros., Inc.* v. *Commissioner*, 35 T.C. 299 (1960), nonacquiescence at page 6 of this Bulletin, where part of the funds used by the corporation to purchase assets of a new business activity were borrowed from some non-stockholders who several months after the purchase acquired about 46 percent of the corporation's stock in exchange for the indebtedness owed them.

For a discussion of the Service position with respect to the application of *Libson Shops* to a merger or other transaction described in section 381(a) of the Code, see Revenue Ruling 58-603, C.B. 1958-2, 147. Further Service views concerning the application of *Libson Shops* are set out in Revenue Ruling 59-395, C.B. 1959-2, 475.

2. Advice has also been requested whether the Service would apply different treatment to a case involving the same facts as are set out in the foregoing except for a difference in the method of acquisition by *M* corporation of the assets of *N* corporation. In this second case *M* corporation first attempted in extended negotiations to purchase the assets of *N* corporation but the shareholders of *N* corporation were unwilling to consummate the transaction except by way of the sale of their stock to *M* corporation. *M* corporation purchased the stock of *N* corporation for cash, at fair market value, solely for the purpose of acquiring its assets to earn a profit with those assets and *immediately* liquidated that corporation under such circumstances that the basis of the assets to *M* corporation

will be determined by the amount it paid for the stock of *N* corporation.

Under the facts of this second case, the Service will not contend that the acquisition of control of *N* corporation has as its principal purpose the evasion or avoidance of Federal income tax for purposes of section 269(a) of the Code. Accordingly, section 269 of the Code will not, under these facts, bar the *M* corporation from carrying over its prior losses and the conclusion reached with respect to the first case is equally applicable here.

No opinion is expressed as to other cases where the facts show that the purchase price is payable over a substantial period of time (whether or not specifically payable only out of earnings of the business) or exceeds fair market value or where other circumstances may justify the application of section 269 of the Code.